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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. ____

[illegible] INSURANCE FOAMITE CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

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OCTOBER TERM, 1960

No.

AMERICAN-LAFRANCE-FOAMITE CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

American-LaFrance-Foamite Corporation, hereinafter referred to as "petitioner", prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above entitled case on December 13, 1960.

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit (Appendix A hereto) is officially reported at 284 F. 2d 723. The Findings of Fact and Opinion of The Tax Court of the United States (Page 3a of "Appendix to Petitioner's Brief" in the United States

Court of Appeals herein, nine copies of which have been filed herewith) filed on May 19, 1959, not officially reported, is reported at 18 CCH Tax Ct. Mem. 447 (1959) and ¶59,101 P-H Memo TC.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit (Appendix B hereto) was entered on December 13, 1960. The jurisdiction of this Court is invoked under 26 U.S.C. §7482(a) and 28 U.S.C. §§1254(1) and 2101(c).

Question Presented

Did the United States Court of Appeals apply the proper standard to essentially undisputed facts in determining that as a matter of federal income tax law advances by petitioner over a period of several years to a corporation of which it owned 51% of the stock were *not loans* creating a debtor-creditor relationship which entitled petitioner to deduct the unrecovered balance of the advances as a worthless debt in petitioner's 1951 income tax return but *were capital investments* subject to capital loss limitation?

Statute Involved

The following sections of the Internal Revenue Code of 1939, as amended, are involved:

"§23. *Deductions from gross income.*

In computing net income there shall be allowed as deductions:

• • • • •

(g) *Capital losses.*

(1) *Limitation.* Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

* * * * *

(k) *Bad debts.*

(1) *General rule.* Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness debt, as defined in paragraph (4) of this subsection. * * *"

"§117. *Capital gains and losses*

* * * * *

(d) *Limitation on capital losses.*

(1) *Corporations.* In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges."

* * * * *

[26 U.S.C. (I.R.C. 1939, as amended) §§23 and 117]

Statement

There is essentially no dispute as to the facts material to consideration of the question presented.

Some time prior to 1942 Louis F. Fink conceived the idea of using two parking meters on one head and base to control two parking places and applied for a patent of this invention (4a*). In 1942 he assigned the patent application to International Meters, Inc. (hereinafter referred to as IMI) in consideration for shares of stock issued by that corporation (5a). During the years 1942 through 1946 IMI obtained a patent on the twin meter and devoted its time while awaiting the end of the war to perfecting hand-made models of the meter (5a, 98a).

In 1945 Fink was introduced to Edward E. O'Neill, the then president of American-LaFrance-Foamite Corporation, petitioner herein, a leading manufacturer of fire fighting equipment sold chiefly to municipalities (5a, 99a). Fink testified that prior to meeting O'Neill he and the other stockholders in IMI had intended to produce and sell the twin meter but that after meeting O'Neill the thought occurred to him that petitioner, which had participated for so many years in the business of supplying municipalities, would be ideal as a company to produce and sell the twin meter and to reduce the possible sales resistance to the introduction of a new item in the parking meter field (99a).

At a meeting of the Board of Directors of petitioner held on January 16, 1946, O'Neill reported that 51% of the common stock of IMI could be purchased by petitioner from Fink for $50,000 and that if such purchase were made petitioner would manufacture the twin meter for IMI. It was estimated that on a conservative basis petitioner would make a profit by the sale of twin meters to IMI of about

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* Page references in the "Statement" refer to the "Appendix to Petitioner's Brief" in the United States Court of Appeals herein, nine copies of which have been filed herewith.

$160,000 a year. In addition, it was estimated that IMI as a sales organization for the twin meter should gross about $490,000 profit per year less operating expenses "which should not be very much" (29a) and that petitioner, due to its stockholdings, would be entitled to 51% of the net profits of IMI. It was indicated at this meeting that petitioner would have to advance IMI its operating expenses to start with, which would be around $60,000 to $70,000 a year (5a-6a, 27a).

Petitioner over a period of many months gave consideration to buying 51% of the common stock of IMI from Fink. During this time petitioner thoroughly investigated the twin meter and the protection afforded by the patent which had been issued therefor (5a-6a).

On February 6, 1947 an agreement was entered into between petitioner and Fink pursuant to which petitioner acquired from Fink for the sum of $50,000 all of the outstanding preferred stock of IMI (400 shares), 51% of the common stock of IMI (714 shares) and the note of IMI for $9,000. By the terms of this agreement petitioner also acquired an option to purchase 343 shares of the common stock of IMI from Fink (such shares representing approximately sixty per cent of Fink's remaining stock interest in IMI as of February 22, 1947) for the book value of such stock at any time after six years from the date of the agreement provided that either of the following two contingencies had occurred: (a) the death of Fink or (b) the termination of Fink's employment by IMI (8a, 9a, 33a).

On February 21, 1947 an agreement was entered into between petitioner and IMI wherein IMI agreed to pay petitioner $53,983.80 which was an amount equal to certain expenditures which had been incurred by petitioner

on behalf of IMI during the year 1946. This agreement also provided that petitioner would loan to IMI sufficient funds to take care of the operating expenses of IMI during the year 1947. Petitioner further agreed to manufacture and sell to IMI parking meters at cost plus 33⅓%. The agreement further provided that IMI would assign to petitioner its accounts receivable as collateral for the sums owed by IMI to petitioner (9a, 38a).

On August 4, 1949 petitioner and IMI entered into an agreement whereby petitioner agreed to loan to IMI sufficient funds to take care of its operating expenses during the years 1948 and 1949. Petitioner further agreed to manufacture and sell to IMI parking meters for the sum of $36.00 per meter or for an amount equal to the manufactured cost plus 20% thereof, whichever amount was the lower. IMI agreed to assign its accounts receivable to petitioner as long as IMI was indebted to petitioner. Petitioner credited collections on said assignments on the indebtedness of IMI to petitioner (9a, 41a).

On January 17, 1951 petitioner and IMI entered into an agreement wherein petitioner agreed to loan IMI sufficient funds to take care of its operating expenses in the years 1950 and 1951 or up to the time when the agreement was terminated as provided for in the agreement if such termination was prior to December 31, 1951. Petitioner agreed to manufacture and sell twin meters to IMI at a certain price, reserving the right however to change the price of the meter without prior notice. This agreement also provided that due to the difficult material situation brought about by the national emergency petitioner reserved the right to curtail or discontinue production of the twin meters at any time. IMI agreed to assign to petitioner its accounts receivable as long as it remained indebted to petitioner. Petitioner credited collections on

said receivables on the indebtedness of IMI to petitioner (10a, 43a).

Pursuant to obligations assumed in the above agreements, IMI became indebted to petitioner for advances in respect of the years 1946 to 1951 as follows (10a-11a):

1946	$ 53,983.80
1947	98,717.20
1948	427,814.99
1949	667,181.40
1950	713,468.17
1951	569,233.50

Commencing in 1948 petitioner recovered from IMI on the above advances as follows (11a):

In 1948	$215,517.42
In 1949	497,431.73
In 1950	712,636.31
In 1951	597,926.54

Thus, during the period from 1946 to 1951, petitioner made advances to IMI totaling $2,530,399.06. In the same period recoveries by petitioner from IMI came to $2,023,512.00.

The advances made by petitioner to IMI were at all times carried on the books of petitioner as an account receivable and were carried on the books of IMI as a liability. Upon receipt of payments by petitioner from customers of IMI, petitioner applied the proceeds to reduce the balance of petitioner's advances to IMI and this reduction in advances was recorded in the intercompany accounts (73a-74a; 80a-83a).

As regards the twin parking meter, the president of petitioner reported to its stockholders in his annual report for the year ended December 31, 1950 as follows:

> "The Twin Automatic Parking Meter sales volume in 1950 increased 45% over 1949. 22,500 units

have been sold, parking about 45,000 cars. Losses were reduced from $122,535 in 1949 to $42,819 in 1950 and our advances to International Meters, Inc. in 1950 were relatively immaterial. Further progress in 1951 seemed assured until the Government placed restrictions on critical materials used in our parking meters. Consequently, we decided to suspend production as soon as our present schedule is completed, until materials are again available with which to resume balanced production. In the meantime parking meter development work is continuing, a complete stock of parts and a trained staff of personnel will be maintained to handle service requirements and a skeleton organization will be retained to preserve the necessary minimum sales contracts" (67a).

Due to material restrictions and increasing costs caused by the National Emergency resulting from the Korean War, petitioner found it difficult to reach a profitable production level of parking meters during the early months of 1951. In consequence of these conditions, petitioner, as majority shareholder of IMI, moved to bring about the liquidation and dissolution of IMI (13a, 70a). At the Special Meeting of the Board of Directors of IMI on August 6, 1951, a resolution recommending dissolution and notice to stockholders was adopted and at a meeting of the stockholders of IMI on August 20, 1951 approval was given to the filing of a certificate of dissolution, which was filed on August 28, 1951 (13a).

The Treasurer of IMI reported that as of December 15, 1951 all known liabilities of IMI had been paid with the exception of the amounts due petitioner. The Treasurer was authorized to pay to petitioner all the cash in the hands of IMI. Immediately prior to the payments made pursuant to this authorization, the balance of

advances made by petitioner to IMI was $568,656.63. Application to this balance of the amount of $61,769.57 left a balance of $506,887.06 of advances made by petitioner to IMI. Petitioner deducted on its income tax for the year 1951 this balance of $506,887.06 as a bad debt (14a).

On February 28, 1956 the Commissioner of Internal Revenue sent to petitioner a notice of deficiency in its federal income tax liability resulting from the disallowance of the above deduction. Thereafter, on May 23, 1956, petitioner filed with the Tax Court a petition for redetermination of such deficiency. On July 24, 1956 the Commissioner filed an answer to said petition, and the proceeding was heard on March 13, 1958 before Honorable Arnold Raum, a Judge of the Tax Court.

On May 19, 1959 Judge Raum filed his opinion, in which he found as an ultimate fact that the $506,887.06 balance of petitioner's advances to IMI represented capital contributions and not a bona fide debt. In so doing, Judge Raum stated that "the matter may not be completely free from doubt" (16a). Thereafter, on August 31, 1959, the Tax Court entered its decision in petitioner's proceeding ordering and deciding that there was a deficiency in income tax for the taxable year 1951 in the amount of $266,558.13.

The petitioner appealed the decision of the Tax Court to the United States Court of Appeals for the Second Circuit. That Court affirmed the decision of the Tax Court by judgment entered December 13, 1960, and it is from this judgment that petitioner prays that a writ of certiorari issue to review.

Reasons for Granting the Writ

Petitioner believes that a writ of certiorari should issue to review the judgment of the United States Court of

Appeals for the Second Circuit herein for the following reasons:

1. The decision below is in direct conflict with the decision of the United States Court of Appeals for the Sixth Circuit in *Byerlite Corporation* v. *Williams, District Director of Internal Revenue*, 61-1 CCH U. S. Tax Cas., Par. 9138, decided December 15, 1960, two days after the decision below herein. (The opinion in *Byerlite* is reproduced as Appendix C hereto, 8A-26A*.)

2. The number of cases arising each year in the Tax Court, the United States District Courts, the United States Court of Claims, and the United States Courts of Appeals involving the question of whether for purposes of federal income tax law advances constitute debt or contributions to capital, and the related question of whether payments made by a corporation constitute interest on loans or distributions of profits in the form of dividends, are numerous and have been decided by the various courts without the same emphasis being given to the same criteria and without consistent application of the same standards in the determination of the issue of tax liability. This Court has never given an authoritative guide to the lower courts by establishing standards, the application of which would promote consistency and equality of treatment in cases arising in this important area of tax law.

3. There is no basis in the record herein for a finding that the relevant advances were capital contributions and not bona fide debt. The case therefore presents excellent opportunity for meeting the compelling demand for the creation of standards which will promote consistency and equality of treatment in this area.

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* Citations herein denoted "A" preceded by a number refer to page numbers of Appendices to this Petition.

ARGUMENT

I

The decision herein is in direct conflict with a decision of the Sixth Circuit.

The decision below is in direct conflict with the decision of the U. S. Court of Appeals for the Sixth Circuit in *Byerlite Corporation* v. *Williams, District Director of Internal Revenue*, 61-1 CCH U. S. Tax Cas., Par. 9138 (not yet officially reported), decided December 15, 1960, two days after the decision below herein.

A reading of the opinion below herein and of the opinion of the Sixth Circuit in the *Byerlite* case clearly indicates an application by the respective courts of two different standards in determining essentially the same issue of tax liability and consequently the taxpayers involved have not received equal treatment.

The facts in the two cases are amazingly similar. The facts herein are presented in the "Statement" above. The facts in the *Byerlite* case appear at length in the opinion of the Sixth Circuit (Appendix C hereto) and a brief summary thereof is as follows:

Byerlite Corporation (hereinafter referred to as Byerlite) entered into an agreement to purchase and remove over a period of time certain residual materials from property located in the Netherlands West Indies. Byerlite, due to its concern about doing business in a colonial territory, organized a wholly-owned subsidiary corporation referred to herein as "Export". Export's authorized capital consisted of 10,000 shares of common stock, par value $5 per share. However, only six shares of Export were ever purchased and these were purchased by Byerlite for the sum of $30. Certificates for these shares were

never issued nor did Export ever possess a stock certificate book.

Export, by agreement with Byerlite, assumed the job of actually removing the residual materials from their locale and placing them aboard ship for export to world markets. Byerlite retained for itself the responsibility for financing the entire transaction and trans-shipping the materials once they were aboard ship to world markets for resale.

Prior to the incorporation of Export, Byerlite had expended $88,000 for the purchase of machinery and other items to be used in the removal of the materials. After Export had been organized, the said $88,000 was entered on the books of Byerlite as an advance to Export and on the books of Export as an account payable to Byerlite. It was estimated that additional expenditures in large amounts for machinery, equipment and other items would be required to be advanced by Byerlite to Export. Such expenditures were thereafter advanced by Byerlite and charged to Export as loans. The advances to Export by Byerlite were made without requiring any evidence of indebtedness or fixing any date for repayment and without requiring the payment of any interest and with the realization that the tangible assets of Export were not such at any given time as to repay any part of the loan.

The original plan called for the payment by Byerlite to Export of a service fee over and above the expected cost of operation as compensation for removing the materials and preparing them for shipment. It was from these service fees payable to Export that Byerlite expected to be repaid for the advances it had made to Export.

At the time of the organization of Export, Byerlite's contract for the purchase and removal of the residual materials appeared to be a valuable asset. However,

thereafter, it became impossible to resell the residual materials in the manner anticipated. Because of the change in conditions, the original plan was modified and Export made a few direct sales of some of the materials to third parties and also rented its properties and equipment to others. Export operated at a substantial loss each year of its existence, but Byerlite continued to make advances shown on its books as accounts receivable and on Export's books as accounts payable. These advances were made even though "The future seemed to hold little hope for the venture" (61-1 CCH U. S. Tax Cas., p. 79, 224; 16A).

In December 1950, about three years after Export had been organized, Export owed Byerlite a sum in excess of $564,000. During that month Byerlite's contract for the purchase and removal of the residual materials was cancelled by the other party thereto. Shortly thereafter, Export was dissolved and its assets were transferred to Byerlite. The gross value of these assets was about $121,000.

Byerlite deducted the value of the assets from the total advances made to Export and on its federal income tax return applied the difference, amounting to $442,966.62, as a deduction for a bad debt from its ordinary income in 1949 and 1950. The Director of Internal Revenue disallowed the deduction on the ground that the advances to Export were contributions to capital and not loans; Byerlite paid $116,257.91 under protest and sued for recovery in the U. S. District Court. The U. S. District Court held for the Government and Byerlite appealed to the Sixth Circuit, which reversed the District Court.

In his decision, Chief Judge McAllister of the Sixth Circuit stated:

> "On the books of Byerlite, the advances to Export were carried as accounts receivable; on Export's

books, as accounts payable. This is the nomenclature of debt. Of course, the government is not bound in its tax collecting activities by the terminology used by a taxpayer if such terminology is used to disguise something quite different. However, if the stockholders of a corporation determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit, and, when the venture is closed up, they take their loss as to such amount as they have loaned, and this leaves them in a position to enjoy more favorable deduction privileges than if they had put it all in as capital, this does not entitle the Commissioner of Internal Revenue to rewrite their balance sheet for them and show to be capital what was intended to be a loan. *Rowan* v. *United States*, 219 F.2d 51 (C. A. 5). The decisive factor is not what the payments are called but what, in fact, they are, and that depends upon the real intention of the parties. *United States* v. *Title Guarantee & Trust Co.*, 133 F. 2d 990 (C.C.A. 6); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6). The indicia relied upon by the government are not controlling. The fact that advancements to a corporation are made without requiring any evidence of indebtedness or fixing any date for repayment; without requiring the payment of any interest; and with the realization that the tangible assets of the corporation were not such, at any given time during the taxable period, as to repay any part of the loan—was not a controlling consideration requiring a conclusion that the advances were not loans, and that a deduction from ordinary income for a bad debt was not properly allowable, when the advances became uncollectible (61-1 CCH U. S. Tax Cas., pp. 79, 224-79, 225; 17A-18A).

* * * * *

"The cases hold that, for tax purposes, transactions are to be disregarded if they are a sham or

masquerade, or if they take place between taxable entities which have no real existence. 'The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact.' *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, 128 (C. A. 2). In all cases, the prevailing consideration is that artifice must not be exalted over reality, whether to the advantage of the taxpayer, or to the government (61-1 CCH U. S. Tax Cas., p. 79, 225; 20A).

* * * * *

"In the presence of circumstances showing a usual course of business, as reflected on the books of a taxpayer, and in the absence of any circumstances from which sham could be inferred, it is only by artifice and fiction that a conclusion could be drawn that the circumstances are not what they purport to be and that what appears from all the evidence to be loans is to be interpreted as an investment in stock" (61-1 CCH U. S. Tax Cas., p. 79, 227; 25A).

Thus the Sixth Circuit emphasizes that the "real intention of the parties" is the decisive factor and indicates that in the presence of circumstances showing a usual course of business as reflected on the books of the taxpayer and in the absence of sham the Court will not allow the Commissioner of Internal Revenue to rewrite the taxpayer's balance sheet and show to be capital what was intended to be a loan. In short, the standard adopted by the Sixth Circuit requires an attempt to determine whether the parties involved intended at the time the transaction took place to create a debtor-creditor relationship and if the actions of the parties indicate an intent to create such a relationship, such intent, absent sham or masquerade for tax purposes, will govern. It should be noted that the Sixth Circuit emphasizes that the intent to be established is whether there was to be a debtor-creditor relationship.

The Court below adopted an entirely different standard to be applied in this type of case. After stating that "it is said that *'the intention of the parties* is a major factor in determining the true nature of the relationship' (Jennings *v.* United States, 7 Cir., 1959, 272 F. 2d 842)", the Court below goes on to state that:

> "• • • However, 'intention' is often a highly artificial and hypothetical concept because most frequently business ventures originate and are carried on without any clear intent as to tax consequences. If the venture is directed from the start by tax counsel and accountants, it is likely that the advances will be definitely recognizable as loans or capital contributions. Absent, however, any such direction, the ultimate outcome, the success or failure of the venture, may well dictate a preferred tax treatment which was not intended or even foreseen at the inception of the venture.
>
> The 'substance' rather than the 'form' of the transaction has frequently been stressed. • • • In final analysis, it is from that composite of all the facts that an attempt must be made to create a probably nonexistent intent and to decide in relation to accepted business practices whether the 'loan' pan of the scale is heavier than the 'capital contribution' pan" (284 F. 2d at p. 724; 3A).

What the Court below appears to consider significant in this type of case is the existence of an intent on the part of the parties as to tax consequences. That this is not the intent the Courts should solely concern themselves with is emphasized by the Sixth Circuit in *Byerlite*. In that case the very fact that no tax avoidance intent was present led to the conclusion that the transaction should be characterized in the manner intended by the parties themselves. In the case herein, it is apparently this lack

of consideration given by the parties to tax consequences that the Court below had in mind when it stated "that an attempt must be made to create a probably nonexistent intent", since it is very clear that the parties intended to create a debtor-creditor relationship, and, in fact did so, in so far as the relevant state law is concerned, i.e. New York. *Wallach* v. *Dryfoos*, 140 A. D. 438, 125 N. Y. S. 305 (1910); *Minevitch* v. *Puleo*, 9 A. D. 2d 285, 193 N .Y. S. 2d 833 (1959). The only question to be decided herein is whether this intent, as established by all the actions of the parties, should be disregarded for purposes of federal income tax law. The Court below acknowledged that the books and financial statements of petitioner and IMI and the fact that the advances were not made in proportion to stockholdings and were partially repaid* supported the characterization of the transaction as a debtor-creditor relationship. The Court could well have stated that all of the actions of the parties from the time they first came in contact with one another up until and including the dissolution of IMI consistently indicated an intent to create and the creation of a debtor-creditor relationship. However, the Court below apparently gave particular emphasis to the fact that no notes were given, no maturity date was fixed, no interest was charged, and repayment was contingent upon the success of the venture. The Sixth Circuit held these very factors not to be controlling in *Byerlite* where the Court stated:

> "The indicia relied upon by the government are not controlling. The fact that advancements to a cor-

* It should be noted that in *Byerlite* there was no partial repayment and no proportionality of advances could exist since there was only one stockholder. Thus the case at bar presents a stronger factual basis for recognition of an intent to both create and operate a debtor-creditor relationship than was the case in *Byerlite*.

> poration are made without requiring any evidence of indebtedness or fixing any date for repayment; without requiring the payment of any interest; and with the realization that the tangible assets of the corporation were not such, at any given time during the taxable period, as to repay any part of the loan—was not a controlling consideration requiring a conclusion that the advances were not loans, and that a deduction from ordinary income for a bad debt was not properly allowable, when the advances became uncollectible" (61-1 CCH U. S. Tax Cas., p. 79, 225; 18A).

After rejecting all of the uncontradicted evidence in the record which indicated that the intent of the parties was to create a debtor-creditor relationship, the Court below revealed what was apparently its real reason for affirming the Tax Court by stating "it is difficult to reconcile these large advances, made to a company with no assets of any substance and no prospects other than the success of the venture, as 'loans'" (284 F. 2d at p. 725; 5A-6A). Here, once again, the Court below is in direct conflict with the Sixth Circuit. That Court indicated that "One who makes a loan to a corporation also takes a risk, and while he may receive evidence of an obligation, payable in any event, often such obligation is never paid" (61-1 CCH U. S. Tax Cas., p. 79, 226; 21A-22A).

In the last analysis both the Tax Court and the Second Circuit apparently held against the petitioner solely because comparatively large sums of money had been advanced by petitioner to IMI. In so doing, both Courts ignored the fact that the record shows that at the time the transaction commenced it was not thought likely that substantially large sums would have to be advanced by petitioner to IMI. It was only after petitioner had

decided to go forward and had made its initial advances that it became apparent that additional advances would have to be made. Moreover, it should be emphasized that petitioner was always confident that the advances made to IMI would be repaid, and, in fact, out of advances of slightly more than $2,500,000 a total in excess of $2,000,000 was repaid by IMI; most of the partial repayments were made by way of collections of IMI accounts receivable which had been assigned to petitioner pursuant to the written loan agreements. It should be noted that large sums were advanced by Byerlite to Export and that Export never did make any substantial amount of money. In both *Byerlite* and the case now before the Court, the borrowers became unable to repay the advances which had been made to them because of unforeseeable changes in production and marketing conditions. In the case of *Byerlite* the unforeseen and significant event was the apparent reduction in demand for the materials involved and in the case now before the Court the unforeseen and significant event was the intervention of the Korean War, resulting in the inability to obtain production materials. Thus, in both cases, an unforeseen event beyond the control of the parties arose after the transaction had been entered into and gave rise to the respective business failures resulting in the losses which both *Byerlite* and petitioner legitimately attempted to write off as a bad debt. In the case of *Byerlite*, the Sixth Circuit, giving recognition to the intent of the parties, has allowed the bad debt deduction. In this case, the Courts thus far have refused to give recognition to the intent of the parties and in so doing have refused to allow petitioner its bad debt deduction.

II

Non-existence of authoritative standards to be applied in this area of recurring cases.

The number of cases arising each year in the Tax Court of the United States, the United States District Courts, the United States Court of Claims and the United States Courts of Appeals involving the question of whether for purposes of Federal income tax law advances constitute debt or contributions to capital, and the related question of whether payments made by a corporation constitute interest on loans or distributions of profits in the form of dividends, are numerous and have been decided by the various courts without the same emphasis being given to the same criteria and without consistent application of the same standards in the determination of the issue of tax liability.

There is no question but that each year there are many cases arising in this area of tax law. As the Court below stated "The necessity for resolving this question (namely, loans or capital contributions) has arisen many times and doubtless will arise many times in the future" (284 F. 2d at page 724; 2A). In order to present to this Court some indication of the number of cases and the variety of courts concerned with the question presented herein there are listed in Appendix D hereto some of the cases decided in 1959 and 1960 which involved the question of whether for tax purposes advances were to be classified as loans or capital contributions. An examination of the twenty-nine cases listed in Appendix D will confirm that the question involved herein has within the past two years been presented to United States Courts of Appeals or United States District Courts in all but three of the

Judicial Circuits, as well as to the Tax Court and the Court of Claims.

The only occasion in which the question involved herein has been considered by this Court was in the companion cases of *John Kelley Co.* v. *Commissioner of Internal Revenue* and *Talbot Mills* v. *Commissioner of Internal Revenue*, 326 U. S. 521 (1946). These cases involved the issue of whether payments made by corporations were to be characterized for tax purposes as interest or dividends. They were decided while the rule in *Dobson* v. *Commissioner of Internal Revenue*, 320 U. S. 489 (1943) was still operative and prior to the nullification of the holding therein by amendment in 1948 of §1141(a) of the Internal Revenue Code of 1939 (now 26 U.S.C. (I.R.C. 1954) §7482(a)). In these cases the majority of this Court adhering to the *Dobson* decision refused to lay down any legal rule for distinguishing debt from stock, holding that this was a question of fact for the trial tribunal to decide. By way of dictum certain members of this Court indicated some criteria which might be considered in cases in this area but no attempt was made to give any indication to the lower courts as to the relative importance of the various criteria, or in general what standard was to be applied in determining the question of tax liability.

Thus this Court has never given an authoritative guide to the lower courts which would promote consistency and equality of treatment in the numerous cases arising in this important area of tax law. Consequently, the cases in this area have been decided according to the individual predilection of the judge or judges before which the particular case happened by chance to come. The various courts involved have not considered the same criteria and have not applied the same standard in deciding these

cases and as a result the right of taxpayers to be treated with equal justice before the law has been denied. See 34 *Tulane Law Review* 99 (1959).

If consistency and equality of treatment in this area of federal tax law is to be established, this Court must give guidance to the lower courts. As stated by Dean Griswold in the course of a discussion of certain tax cases decided by this Court last year:

> "• • • It is no doubt true that a standard established by the Court as a construction of the statutory provision would not decide every conceivable case that might arise. It is the nature of legal questions that many of them fall between earlier decisions, or very close to the line, and thus require further refinement, or even qualification, of earlier decisions in the field. But that is no reason for not providing guidance which will resolve a large proportion of the cases, and, even more important as a practical matter, will enable administrative officers and counsel advising clients to resolve many of the problems long before they develop into disputes or litigation." (74 Harv. Law Rev. at p. 89)

Since a petition for writ of certiorari is not intended to perform the function of a brief, it would be inappropriate to examine in detail herein the possible standards which could be adopted by this Court as guides in this area. However, it is suggested that the position taken by the Sixth Circuit in *Byerlite* (Appendix C hereto) might be adopted as the general rule. That is to say, if the evidence establishes that the actions of the parties at the time the advance is made indicate an intent that the advance is to be a loan and not a contribution to capital, such intent should prevail for purposes of Federal income tax characterization so long as the parties have a legiti-

mate business purpose for setting up the transaction in the form used and so long as the transaction is not shown to be a sham or masquerade for purposes of tax avoidance, in which event the doctrine of substance in place of form would govern. *Gregory* v. *Helvering*, 293 U. S. 465 (1935); *Knetsch* v. *U. S.*, 364 U. S. 361 (1960). It is further suggested that this Court might adopt some reasonable debt-equity ratio rule to be applied in the doubtful cases in which no clear intent of the parties can be discerned from the evidence and in those cases in which the evidence supports a finding that the advances are to be considered partially debt and partially contribution to capital. Support for this possibility of division between debt and equity in some cases is found in the language of § 23 (k)(1) of the Internal Revenue Code of 1939 reading:

> "* * * when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

reenacted in clearer form as § 166 (a)(2) of the Internal Revenue Code of 1954.

The form that the rule or standard would take is, however, relatively unimportant. The essential need is for this Court to establish *some* rule or standard as a guide for the lower courts so as to introduce a degree of consistency and equality of treatment in this area and to provide taxpayers, their counsel and the Commissioner of Internal Revenue with some clue as to the tax rule to be applied to a frequently recurring business problem.

III

The opportunity herein for the creation of authoritative standards.

Arguments I and II above present the important reasons why this Court should give consideration to the establishment of a standard to be applied by the various federal courts in this area of tax law. This section is intended to indicate briefly why this case provides the appropriate occasion for the creation of such a standard.

The record in the case herein shows that petitioner and IMI had every intention to create a bona fide debtor creditor relationship and nothing else, that the parties at all times acted consistently with the existence of such a relationship, and that such a relationship was created for legitimate business purposes, and not as a sham or masquerade or plan of tax avoidance.

Original records of petitioner prior to any of the advances to IMI show that petitioner intended such advances as were to be made to be loans and not contributions to capital. The other major stockholder of IMI, who was called as respondent's witness, testified that he was perfectly happy with this arrangement. The written loan agreements between petitioner and IMI pursuant to which the advances were made leave no doubt but that the advances constituted loans and not capital contributions and said agreements created a debtor creditor relationship under relevant state law. The books and records of both petitioner and IMI reflected the advances as indebtedness of IMI to petitioner. The independent public accountants who audited the accounts of petitioner

and of IMI confirmed each year in the audited reports of the two corporations the net amount of indebtedness of IMI to petitioner and the annual reports published by petitioner reflected the indebtedness in like manner. The repayments made by IMI to petitioner over a period of years pursuant to the written loan agreements were likewise reflected on the books and records of both petitioner and IMI as repayment of indebtedness. The distribution of the assets of IMI at the time of its dissolution also is indicative of the intent of the parties to create a debtor creditor relationship. All assets remaining in the possession of IMI were at that time turned over to petitioner and were credited to the balance of advances previously made by petitioner to IMI. If petitioner and IMI had intended petitioner's advances to be contributions to capital rather than loans, the stockholders of IMI other than petitioner would have been entitled to their proportionate share of the distribution made by IMI at the time of its dissolution. Thus the actions of the parties concerned at all times commencing prior to the making of the advances and concluding with the dissolution of IMI indicate an intent to create a debtor creditor relationship and, in fact, such a relationship was created.

Normal and proper business practice dictated the action of the parties in creating this debtor creditor relationship. The facts herein represent a typical situation of an inventor who has created a valuable invention, requesting an established company to aid in its manufacture and distribution. The company giving such aid agrees to do so but only on condition that the moneys expended by it in the manufacture and distribution process be repaid prior to any sharing in profits by the inventor. In the case herein this was to be accomplished by having

IMI repay petitioner all of its advances prior to the declaration of any stock dividend in which both petitioner and the inventor would have participated as stockholders. The record shows that both petitioner and the inventor, prior to the unforeseen national emergency brought on by the Korean War, were confident that the venture would be a success and, in fact, IMI's sales amounted to almost $2,000,000 as is indicated by the amount repaid to petitioner by way of collections on accounts receivable.

It might be pointed out that if the parties at the time the advances were made had not been so confident of success and had given consideration to methods of tax avoidance in the case of failure they might have set up the transaction in such a fashion as to have prevented any possibility of unfavorable tax consequences. This could have been accomplished by having petitioner purchase the parking meter patent from IMI pursuant to an agreement to pay a royalty. Then petitioner could have taken as ordinary business deductions all the royalties and expenditures made in the course of producing and selling the meters. The fact that the parties chose a different course of action and did not consider methods of tax avoidance should not be reason for imposing tax liability, if in order to do so a distortion of the true intent of the parties has to be made.

The Government has never made any claim that the transaction as indicated by the books, records, statements and actions of the parties was a sham or masquerade for the purpose of tax avoidance. Absent the presence of any such sham or masquerade the intent of the parties to create a debtor creditor relationship for a legitimate business purpose should be honored.

CONCLUSION

For the foregoing reasons the petition for writ of certiorari should be granted.

Respectfully submitted,

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March 9, 1961.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 9—October Term, 1960.

(Argued November 16, 1960 Decided December 13, 1960.)

Docket No. 26030

AMERICAN-LA FRANCE-FOAMITE CORPORATION,
Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before:

LUMBARD, *Chief Judge*, and
WATERMAN and MOORE, *Circuit Judges.*

MOORE, *Circuit Judge:*

By petition for review, petitioner, American-La France-Foamite Corporation, seeks to reverse so much of a decision of the Tax Court as denied petitioner a deduction of $506,887.06 in its 1951 income tax included in its return as a worthless debt. As a result of this disallowance, a deficiency in income tax of $266,558.13 was assessed.

The sole question presented is whether advances made during the years 1947[1] to 1951 by petitioner to Interna-

1. The petitioner's books actually show a balance of unpaid advances for 1946 although this amount was included as an item agreed to be paid in the February 21, 1947 agreement.

tional Meters, Inc. (IMI) represented capital contributions or loans. If they were loans, they were deductible in 1951, the year of the liquidation of IMI (Section 23(k)); if capital contributions, their deduction was limited by Sections 23(g) and 117 of the Internal Revenue Code of 1939.[2]

The necessity for resolving this question (namely, loans or capital contributions) has arisen many times and doubtless will arise many times in the future. The solution of the problem which the courts face in these cases usually is difficult. The situations in which the facts are clear as to whether the advances should fall into one category or the other will rarely reach the courts; only the borderline cases will be litigated. As the Tax Court here quite accurately said, "the matter may not be completely free from doubt" but, since decision is necessary, it must be based upon "our best judgment on the entire record . . ."

The courts have sought to set up several guideposts along the path towards a correct and just decision. Thus,

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2. Internal Revenue Code of 1939:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(g) Capital Losses.—

(1) Limitation.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in Section 117.

Sec. 117. Capital Gains and Losses.

(d) [As amended by Sec. 150(c), Revenue Act of 1942] Limitation on Capital Losses.—

(1) Corporations.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

it is said that "*the intention of the parties* is a major factor in determining the true nature of the relationship" (*Jennings* v. *United States*, 7 Cir., 1959, 272 F. 2d 842). However, "intention" is often a highly artificial and hypothetical concept because most frequently business ventures originate and are carried on without any clear intent as to tax consequences. If the venture is directed from the start by tax counsel and accountants, it is likely that the advances will be definitely recognizable as loans or capital contributions. Absent, however, any such direction, the ultimate outcome, the success or failure of the venture, may well dictate a preferred tax treatment which was not intended or even foreseen at the inception of the venture.

The "substance" rather than the "form" of the transaction has frequently been stressed (*Commissioner* v. *Court Holding Co.*, 324 U. S. 331 (1945); *Gilbert* v. *Commissioner*, 2 Cir., 1959, 262 F. 2d 512, cert. den. 359 U. S. 1002 (1959)). In final analysis, it is from that composite of all of the facts that an attempt must be made to create a probably nonexistent intent and to decide in relation to accepted business practices whether the "loan" pan of the scale is heavier than the "capital contribution" pan.

The venture giving rise to this controversy (except for some preliminaries in 1946) commenced in 1947 when petitioner purchased for $50,000 fifty-one percent (51%) of IMI's common stock, 400 shares of preferred stock and a $9,000 note. IMI had been in existence for some six years primarily to exploit a parking meter which by means of two meters on one head could control two parking spaces. The general plan was to have petitioner manufacture the meters and IMI to act as the selling agent. For various

reasons the operation did not proceed as rapidly or as successfully as contemplated. IMI had virtually no money during its corporate existence so that all financing had to come from petitioner during the five years of their joint enterprise. Substantial advances were made during these years by petitioner and certain repayments largely from the assignments of meter purchase contracts were received. Nevertheless, the balance against IMI continued to increase.[3] Finally in 1951 the contract between petitioner and IMI was terminated and IMI was liquidated, its assets sold and the proceeds applied against petitioner's account, reducing the balance to the $506,887.13 here involved.

Although IMI existed as a separate corporation, it was petitioner which made its operations possible. For all practical purposes, the parking meter was just another item petitioner was manufacturing and marketing through a selling agent. Petitioner's stockholders were told that "During the past two years, approximately, we [petitioner] have been developing and testing a new type of parking meter * * *" and "We recently acquired that company [IMI] and will have complete control of its operations."[4] A year later after "We spent $148,700 on the Tavin Parking Meter project in 1947," stockholders were notified that "parking meters are coming off the produc-

3.

Year	*Balance*
1946	$ 53,983.80
1947	98,717.20
1948	364,998.57
1949	534,748.24
1950	535,580.10
1951	575,987.08

4. Report to Stockholders under date of March 24, 1947.

tion line for sales representative purposes and deliveries to customers should start in April."[5] Towards the end, the report advised that "Losses were reduced from $122,535 in 1949 to $42,819 in 1950 and our advances to International Meters, Inc. in 1950 were relatively immaterial."[6]

Petitioner to support a debtor-creditor relationship points to the fact that both petitioner and IMI on their books and financial statements treated the advances as loans; that the advances were not in proportion to the stockholdings and that the advances were partially repaid.

The Commissioner buttresses his stand by asserting that the "loans" were not made to a "going business" but were for the purpose of getting the business going; that no notes were given to evidence the so-called indebtedness; that no time was fixed for repayment; that no interest was charged; and that IMI's financial condition was so weak that repayment was entirely contingent upon the success of the venture.

Petitioner, in turn, cites cases showing that notes, maturity date and certainty of payment are not necessarily determinative. (*Rowan* v. *United States*, 5 Cir., 1955, 219 F. 2d 51, 55; *Wallach* v. *Dryfoos*, 140 App. Div. 438, 440, 125 N. Y. S. 305 (1910); *Minevitch* v. *Pulco*, 9 A. D. 2d 285, 193 N. Y. S. 2d 833 (1959); *Earle* v. *Jones*, 9 Cir., 1952, 200 F. 2d 846, 851.) On their own particular facts, the courts in these cases have found that the weight of evidence justified the conclusion of a debtor-creditor relationship. These cases, however, only serve to create the

5. Report to Stockholders under date of March 28, 1948.
6. Report to Stockholders under date of March 23, 1951.

doubt which the Tax Court said this case is not "completely free from." Yet, viewing in proper perspective the venture from beginning to end, it is difficult to reconcile these large advances, made to a company with no assets of any substance and no prospects other than the success of the venture, as "loans." See *John Kelley* v. *Commissioner*, 1946, 326 U. S. 521, 526; see also *Gilbert* v. *Commissioner*, 2 Cir., 1957, 248 F. 2d 399, 407; *Note, Thin Capitalization and Tax Avoidance*, 55 Colum. L. Rev. 1054 (1955). The Tax Court has fairly analyzed the evidence and properly concluded that "the deduction for worthlessness of petitioner's investment must be governed by the provisions relating to capital assets rather than by the bad debt provisions."

The decision of the Tax Court is affirmed.

APPENDIX B

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of December one thousand nine hundred and sixty.

Present—Hon. J. EDWARD LUMBARD, Chief Judge
Hon. STERRY R. WATERMAN,
Hon. LEONARD P. MOORE, Circuit Judges

AMERICAN-LAFRANCE-FOAMITE CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPEALS FROM THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

APPENDIX C

No. 13877

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

BYERLITE CORPORATION, *Plaintiff-Appellant*, v. PARKER C. WILLIAMS, District Director of Internal Revenue, Eighteenth District of Ohio, *Defendant-Appellee*.	Appeal from the United States District Court for the Northern District of Ohio, Eastern Division.

Decided December 15, 1960.

Before MCALLISTER, Chief Judge, POPE, Circuit Judge, and THORNTON, District Judge.

MCALLISTER, Chief Judge. Plaintiff paid income and excess profits taxes for 1949 and 1950 under protest, and brought this action to recover them. It contended that certain advances which it made to an affiliated corporation were loans; that these loans were not repaid; that they, therefore, constituted a bad debt; and that, accordingly, they were deductible, as a bad debt, from plaintiff's ordinary income, under Section 23(k) of the Internal Revenue Code of 1939.

The District Court held that the advances in question from plaintiff to its affiliated corporation were not loans

but, rather, were an investment in the stock of the affiliated corporation, and, therefore, a capital investment therein; that, by virtue of various sections of the Internal Revenue Code, the particular loss, in this case, resulting from such investment and capital asset, was not deductible from plaintiff's ordinary income; and the District Court, accordingly, dismissed the complaint.

The background of the case is as follows: Commencing in 1931, plaintiff Byerlite Corporation engaged in the manufacture and sale of asphalt and allied products. The shares of stock in Byerlite were, and are, held by members of the Myers family, who also manage and direct its business. D. N. Myers is President; Inez Myers, his wife, is Vice President; and Milton Myers, his brother, is Secretary and Treasurer.

In February, 1947, plaintiff Byerlite Corporation learned of the availability of asphaltic materials on the island of Aruba, in the Netherlands West Indies. These asphaltic materials had accumulated from the dumping of oil refinery residue on the property of the Lago Oil and Transport Company, a Canadian corporation. This latter company was an affiliate of the Standard Oil Company of New Jersey. Byerlite, after making an examination of these asphaltic materials, commenced negotiations to purchase them from the Lago company.

On May 7, 1947, a contract of sale of the asphaltic materials was executed between the Byerlite company and the Lago company. According to the contract, Byerlite agreed to purchase and remove a minimum of 600,000 tons of asphaltic pitch, of which 200,000 tons were to be purchased and removed within three and a half years of the

date of the contract, and the balance was to be purchased and removed at the rate of not less than 70,000 tons per year. It was understood that all of the asphaltic materials would be removed within a few years, and, in no event, later than ten years after the contract date.

Shortly after the execution of the contract, Byerlite commenced preparations for the removal of the asphaltic materials. Equipment, machinery, and other properties were purchased and shipped to the island of Aruba. About that time, it occurred to the Byerlite company that it would be advisable to organize a subsidiary corporation, the only function of which would be to carry on the operations necessary to prepare the asphaltic materials for shipment. Byerlite's reason for considering that a subsidiary corporation should be organized arose out of the state of political uncertainty in the world, at that time, affecting colonial governments, and, especially, in this case, the Dutch colonial government. Colonial governments were then toppling and disappearing in all parts of the world, and the Dutch were experiencing much of the brunt of this great political change in their colonies. Because of these circumstances, Byerlite desired to avoid risking all of its corporate resources to the liabilities resulting from an operation in a foreign country under Dutch colonial government.

On September 16, 1947, therefore, a subsidiary corporation was organized by Byerlite, and incorporated under the laws of the Dominion of Canada, under the name of the Byerlite Export Company, Ltd., which will hereafter be referred to as "Export." The authorized capital of Export was 10,000 shares, having a par value of $5.00 per share.

However, only 6 shares of Export were ever issued, and they were issued to Byerlite for the sum of $30.00; but no certificates of stock were ever issued by Export, nor did it possess a stock certificate book.

In formulating the idea of a subsidiary corporation, and in conducting the business at Aruba through such an organization there, the Byerlite company did not contemplate tax evasion, or tax avoidance, or tax savings; it gained no operating advantage by conducting part of its business through the subsidiary; and it, further, gained no operative advantage by the use of a foreign, rather than a domestic, subsidiary. Its sole purpose, according to the evidence, was to avoid risking all of its assets and resources, used elsewhere, to perilous losses that might result from this relatively minor operation. In brief, then, in organizing Export, the purpose which Byerlite company had in mind was to avoid losing all it possessed, as a result of doing business under a colonial government, at a time when such governments were disappearing, or being overturned by revolution in many parts of the world.

The object and effect of the Byerlite company's organization of its affiliate, Export, was to separate the operation of securing the asphaltic materials from the Lago company into two parts: (1) Export was to carry out the minor operation of removing the asphaltic materials from the premises of the Lago company, and providing island transport of the materials to a port in Aruba from which they could be shipped. (2) Byerlite was to finance the whole project and provide for the trans-shipment and sale to third parties. Thus, Byerlite was to purchase the asphaltic materials and pay the Lago company for them. It was to

pay, to Export, all the expenses in removing the materials, preparing them for shipment, and transporting them to a seaport. It was further to bear the cost of shipment of the materials from the island of Aruba to the place of destination, and to sell and collect from the eventual buyers.

The President of the Byerlite company considered that it would require an expenditure, on Byerlite's part, of approximately $125,000 to commence operations in the island of Aruba, including the cost of the purchase of equipment, machinery, and other items for the removal of the asphaltic materials. Prior to the incorporation of Export, the Byerlite company had paid out of its own funds $88,000 for these purposes. The amount of these expenses was thereafter entered on the books of the Byerlite company as an advance, and was recorded on the books of Export as an account payable to the Byerlite company.

At the time Export was organized, it was estimated that additional expenditures in large amounts for machinery, equipment, and other items would be required to be advanced by the Byerlite company to Export for the purpose of removing the asphaltic materials and preparing them for shipment from a port in Aruba. Such expenditures were thereafter advanced by the Byerlite company, and charged to Export as loans.

The Byerlite company, at the time it entered into the contract with Lago company for the purchase of the asphaltic materials, considered that the contract with the Lago company was a valuable asset. This assumption was based upon the belief that there were markets in Spain, Sweden, France, and Italy for the asphaltic materials.

which, in those countries, are used for the manufacture of fuel in the form of coal briquettes. It was further assumed that the selling price of the asphaltic materials in those foreign countries would be approximately $24.00 per ton; that the cost of removing, preparing, selling, and shipping the materials would be $20.00 per ton; and it was expected, accordingly, that, on the total of 600,000 tons, there would be a yield of profit on the entire transaction of $2,400,000. The Byerlite company expected to ship about 200,000 tons of the material the first year.

The original plan called for the payment by the Byerlite company to Export of a service fee of $1.50 per ton over and above the expected cost of operation for removing and preparing the material for shipment. It was from these service fees, payable to Export, that the Byerlite company expected to receive back the money which it advanced to Export to carry out the operations assigned to it.

The Byerlite company had, and retained as its own, its contract with the Lago company, the vendor of the materials, and was to receive all profits over and above the sum of $1.50 per ton. As stated above, this amount was to be retained by Export as a service fee. But from the aggregate of these service fees of Export, the Byerlite company was to be repaid for its large advances to Export, which the latter company had received for the purpose of the removal and preparation of the materials for shipment. The foregoing was the original plan of the Byerlite company and the Export company. It was subsequently somewhat modified, as hereafter appears, but with no effect upon this case.

Byerlite's contract with the Lago company, shortly after its execution, appeared extremely valuable—and later

dropped to utter worthlessness, resulting in an enormous loss to Byerlite. The drama of this remarkable rise and fall of a promising business venture does not directly bear upon the issues in this case, but is part of the story that accounts for the disaster suffered by Byerlite, and the reasons why it is asking to deduct the loss from income on its tax return.

It developed, then, that within a year of the date of the execution of the contract between the Byerlite company and the Lago company, another Ohio corporation, the Great Lakes Carbon Co., heard of the enterprise, and became greatly concerned in acquiring an interest in it. On April 12, 1948, the Great Lakes company offered to purchase a 50% interest in Export, the subsidiary, for $250,000, and further offered to advance $500,000 by way of loans to the subsidiary, upon certain conditions. One of these conditions was that the Byerlite company's contract with the Lago company was to be assigned to the subsidiary corporation, or to a new corporation; that, further, at the time of the acceptance of the above offer, Byerlite would have advanced or made available to the subsidiary the aggregate sum of $500,000 to be used for the purchase of machinery and equipment; that $300,000 of the aggregate of $500,000, which had been advanced by Byerlite, would be repaid to Byerlite out of the $500,000 advanced by Great Lakes; and that the advances by both Byerlite and Great Lakes were to be covered by promissory notes. It was a further condition that Great Lakes was to have direct management of the company's sales and operations, and to receive a commission of $1.00 per ton on all the asphaltic materials sold.

Appendix C

The net effect of this offer of Great Lakes, if accepted by Byerlite, would have been as follows: Byerlite's total financial investment would have totalled $500,000. In return for 50% interest in the enterprise, Great Lakes would invest $750,000. Of this $750,000, Byerlite would be paid $250,000 for a share of its interest in the subsidiary, and $300,000 as a payment for the advances which Byerlite had made to the subsidiary. In other words, it would receive a total of $550,000 from Great Lakes—which was $50,000 more than would have been its investment in the enterprise. Thereafter, Byerlite and Great Lakes would each own 50% of the enterprise, and the profits would be equally divided between Byerlite and Great Lakes, after Great Lakes had first realized profits from the operations to the extent of $500,000. By this agreement, then, Byerlite would be repaid $500,000—the entire amount it had invested in the enterprise, plus $50,000. Great Lakes would invest $750,000, which it would attempt to recoup by profitable operations, to the extent of $500,000, before sharing profits with Byerlite. Thereafter, Great Lakes, with $250,000 still invested in the company, would share the profits equally with Byerlite.

Byerlite refused the Great Lakes offer as not being adequate. Soon thereafter, it developed that the foreign companies to which Byerlite intended to sell the asphaltic materials would be unable to make payment in American dollars and it became evident that, because of some unexplained circumstances, the demand in those countries for the asphaltic materials disappeared. Immediately, then, it became necessary to look to the American market for customers. But, here, the results were disappointing, and the prospects almost hopeless, since it soon became appar-

ent that the cost of preparing the material for the American market was 150% higher than for the foreign markets. Accordingly, only a few sales were made.

Thereafter, Export, because of expediency, made a few sales of the asphaltic materials to other purchasers, instead of making all of its sales to Byerlite. It then rented its buildings in Aruba, as well as its equipment, and rendered services to others through the use of its equipment and employees.

The future seemed to hold little hope for the venture. Export operated at a substantial loss each year of its existence. Nevertheless, the Byerlite company continued to make advances, shown on its books as accounts receivable, and on Export's books, as accounts payable. In December, 1950, after a little more than three years of existence, Export, according to its books, owed Byerlite $564,661.72.[1]

Thereafter, in December, 1950, the Lago company cancelled its contract with Byerlite because of the failure of Byerlite to purchase a minimum of 200,000 tons of the asphaltic materials within three and one-half years from the date of the contract, as therein provided. Shortly thereafter, Export was dissolved. Its assets were transferred to Byerlite. The gross value of these assets was $121,695.10. The Byerlite company contends that this amount, representing the gross value of Export's assets, should be deducted from the amount of the advances made by Byerlite to Export, which would result in the difference of $442,966.62, which Byerlite lost by reason of such

1. Of this amount, the President of Byerlite, D. N. Myers, had loaned $277,500 to Byerlite, which, as the Court found, "loaned the money received by it from Myers to Export."

advances, and which Byerlite claims it is entitled to deduct from its ordinary income in 1949 and 1950 as a bad debt.

The Director of Internal Revenue held that the advances by Byerlite to Export were not loans, but were contributions to capital, on which no deductions were allowable. The Director's ruling resulted in the payment by the Byerlite company, under protest, of $116,257.91. Appellant then brought suit to recover such payment and in the District Court, the ruling of the Director was sustained; and the Byerlite company has appealed from such holding and judgment.

Although numerous issues were submitted to, and decided by, the District Court, there appears to us only one controlling question in the case: Were the advances made by the Byerlite company to the Export company loans? If they were loans, Byerlite is entitled to deduct the loss on such loans as a bad debt loss, from its ordinary income.

On the books of Byerlite, the advances to Export were carried as accounts receivable; on Export's books, as accounts payable. This is the nomenclature of debt. Of course, the government is not bound in its tax collecting activities by the terminology used by a taxpayer if such terminology is used to disguise something quite different. However, if the stockholders of a corporation determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit, and, when the venture is closed up, they take their loss as to such amount as they have loaned, and this leaves them in a position to enjoy more favorable deduction privileges than if they had put it all in as capital, this does not entitle the Commissioner of Internal Revenue to

rewrite their balance sheet for them and show to be capital what was intended to be a loan. *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5). The decisive factor is not what the payments are called but what, in fact, they are, and that depends upon the real intention of the parties. *United States* v. *Title Guarantee & Trust Co.*, 133 F. 2d 990 (C. C. A. 6); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6). The indicia relied upon by the government are not controlling. The fact that advancements to a corporation are made without requiring any evidence of indebtedness or fixing any date for repayment; without requiring the payment of any interest; and with the realization that the tangible assets of the corporation were not such, at any given time during the taxable period, as to repay any part of the loan—was not a controlling consideration requiring a conclusion that the advances were not loans, and that a deduction from ordinary income for a bad debt was not properly allowable, when the advances became uncollectible. *Lucia Chase Ewing* v. *Commissioner*, 5 T. C. M. 908. Similarly, where a lender was the sole stockholder of the borrowing corporation, the business of which was not prospering, and a substantial part of the money borrowed was used by the corporation for the acquisition of capital assets, the court held that these circumstances, relied upon by the Commissioner, were not sufficient to constitute the advancements a contribution to capital, and were not a basis for disregarding the true intention of the parties to create debts. *Alma Spreckels* v. *Commissioner*, 8 T. C. M. 1113. Moreover, when a partnership acquires capital stock in a corporation in order to help obtain liquor needed in the partnership business, consisting of the sale of liquor for

profit, it was held that the stock was purchased without investment intent, but only for business purposes, *Hogg* v. *Allen*, 105 F. Supp. 12 (D. C. Ga.), aff. 214 F. 2d 640 (C. A. 5); and where a taxpayer was required to purchase shares of stock in one of its supplier corporations in order to obtain merchandise which otherwise would go to a competitor, the court ruled that it was not an investment, even though carried on the taxpayer's books as an "investment account." The court held that the stock was acquired without investment purpose and only for the taxpayer's business purposes and, hence, was deductible as a business expense. *Smith & Welton, Inc.* v. *United States*, 164 F. Supp. 605 (D. C. Va.).

From the foregoing, it appears that losses of great sums of money resulting from large loans to corporations with slight capital, and even purchases of stock in corporations, are held not to be investments in capital, where the intent to invest was not present and where the funds were loaned, or stock purchased, only to promote the business purposes of the stock purchaser or lender.

It is difficult for us to draw any conclusion to the effect that the advances from Byerlite to Export were intended as capital investments in Export. The advances were made to continue and promote the business of Byerlite in selling asphaltic materials. The transaction was intended to be of short duration by all the parties, Byerlite, Export, and the Lago company. There is no charge here, of mala fides; there was no intent to evade or avoid taxes, or to secure tax benefits. There is no reason to consider that Byerlite did not act in accordance with the facts, when it entered the advances to Export on its books as accounts receivable, and Export, on its books as accounts payable. Moreover,

the fact that Export was required to repay Byerlite's advances by the delivery of the asphaltic products, and that Export actually did receive credits from Byerlite for such delivered materials, is a further indication that the advances were intended to be treated, and were treated, as accounts receivable by Byerlite, and as a debt by Export, in the same manner in which they had been treated from the time of the inception of the project three years before.

All of the foregoing circumstances cogently point to the existence of a bona fide debt, and to the conclusion that Byerlite's advances to Export were not investments by Byerlite in the capital stock of Export.

The cases hold that, for tax purposes, transactions are to be disregarded if they are a sham or masquerade, or if they take place between taxable entities which have no real existence. "The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact." *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, 128 (C. A. 2). In all cases, the prevailing consideration is that artifice must not be exalted over reality, whether to the advantage of the taxpayer, or to the government.

In arguing that appellant is not entitled to a bad debt deduction, the government is obliged to contend, as the District Court found, that Byerlite's advances to Export were not loans but were an investment in Export's capital stock. Such a contention is based upon a theory that seems most unreal and artificial. Export had no need to sell stock, and Byerlite had no need to purchase stock to carry out the contemplated operations. To deprive Byerlite of a deduction for a bad debt on the ground that it was investing in Export's stock, rather than loaning money

to Export, would seem to require a complicated, unreal, artificial, assumption to be substituted for an ordinary, normal, and regular method of doing business, which, in this case, was characterized by the absence of any motive to operate otherwise than as shown by the records of the two companies, and with no hint of subterfuge or attempt to evade simple, straightforward business practices—and, certainly, with no thought of advantage in manner of operation, or as to tax consequences.

In its claim that the debts as shown on the books of Byerlite and Export were, in reality, payments from Byerlite to Export for the latter's stock, the government cites *United States* v. *Title Guarantee & Trust Co.*, 133 F. 2d 990, 993 (C. C. A. 6):

> "*The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them."

In its comment on the above, the government says: "In other words, the stockholder intends to make an investment and take the risks of the venture, while the creditor seeks a definite obligation, payable in any event."

But it does not help in the solution of the problem to speak of the man who invests in stock of a corporation as the one who takes the risks and the creditor as the one who seeks a definite obligation, payable in any event. One who makes a loan to a corporation also takes a risk, and while he may receive evidence of an obligation, payable in any

event, often such obligation is never paid. "To say that the advances were 'gambled' and placed at the risk of the business does not help. • • • All unsecured loans involve more or less risk. On all available information, the risk here was a good one. And it cannot be said, in contravention of the testimony at the trial, that the holders • • • had no reasonable expectation that they would be repaid." *Earle* v. *W. J. Jones & Son, Inc.*, 200 F. 2d 846, 851 (C. A. 9).

To recapitulate other circumstances that, in the aggregate, clearly show that the advances by Byerlite were not intended by Byerlite and Export to be an investment in the latter's stock, and were never so considered by the parties, it is to be observed: The transaction was, in form, a loan; it was not adopted as a device for tax evasion, tax avoidance, or even tax benefits; the reason for choosing the debt terminology, "accounts receivable" and "accounts payable," was unrelated to taxes; the transaction was not directed to the subscription of a small investment in the capital stock of the affiliate when a large investment in its stock was required for the operation; the transaction did not supply capital investment which was needed, under the guise of a loan without requiring or expecting payment; the enterprise required only minimum financing for a few years and not a more permanent structure; the description of the advances as accounts payable was used to express the requirement and anticipation that they would be repaid within a few years, as a debt is required and anticipated to be repaid, since, as the District Court found, it was expected by all parties involved that the entire operation would be concluded within a few years of the time of its inception; appellant was pursuing only an operating profit

which was related to its business of processing and selling asphaltic materials; the risk of the entire venture had been assumed, by contract, by appellant, before the subsidiary was organized; appellant gained no operative advantage by conducting its business through the subsidiary; it gained no operative advantage by the use of a foreign, rather than a domestic, subsidiary; appellant's risk for the entire venture continued throughout the period of operations of the subsidiary and throughout the period of the advances made to it; the purpose of the advances was to carry on appellant's business; appellant's risk of its money would have been the same if it had carried on the operation itself, as it was when carried on through the operation of its subsidiary; the subsidiary was required to repay appellant's advances with asphaltic products to be removed from the premises of the Lago company and turned over to appellant; the books of Byerlite and Export showed not only advances to Export, but credits against those advances for goods sold and delivered by Export to Byerlite.

In form, as well as in reality, all of the risk in the entire venture was the risk Byerlite assumed for the purpose of conducting its business. From the evidence, it could not be said that Byerlite intended, or, at any time, was intending to make an investment in Export in order to enjoy Export's chances of profits as there never appears to have been any prospect of Export's making any profit. As far as the evidence discloses, everything that Export would receive in the way of service fees of $1.50 a ton would not repay the advances which Byerlite would be obliged to make to Export, to enable it to remove the materials, prepare them for shipment, and carry them to a port for trans-shipment.

Appendix C

The total of the service fees to be retained by Export at $1.50 a ton on the entire 600,000 tons contemplated in the contract would amount to $900,000, which Export would have to return to Byerlite to the extent of the amounts advanced. From the record, we have no way of knowing how many tons of the material were removed by Export and delivered to Byerlite during the three years of its existence. Certainly, there was only a mere fraction of the total of 600,000 tons actually delivered. $31,879.09 represented the aggregate of Export's sales to Byerlite, as well as to the other parties to whom it sold in trying to delay the final debacle. Byerlite, during this three-year period, advanced to Export $564,661.72, for which it received, at most, a few thousand tons of the asphaltic materials. This suggests, remotely, an approximation of what it would have cost Byerlite to enable its subsidiary to remove, prepare, and deliver 600,000 tons of the asphaltic materials to Byerlite. Nothing in the evidence justifies any conclusion, or belief, or inference, that Byerlite's advances to Export were not loans or that they were intended as an investment by Byerlite made for the sake of enjoying the chances of profit that Export was expected to clear on the transaction.

Nothing could be more unreal, as we look at the whole operation, than to draw the conclusion that Byerlite's advances were intended as investments in Export's capital stock. The risk of loss which was assumed by Byerlite was not assumed so that it could enjoy the chances of Export's profits; that risk was taken in carrying on its business in the procurement and sale of asphaltic materials; and there was never any attempt by Byerlite to avoid that risk, which it carried from the time of the inception of the

contracts with the Lago company—before Export had even been organized—to the conclusion of the Lago project. The risk in the venture which Byerlite sought to avoid was not on the operation of removing and selling the asphaltic materials from the property of the Lago company on the island of Aruba; the risk it sought to avoid was the risk "of all its resources in an operation in a foreign country under Dutch colonial administration."

In the presence of circumstances showing a usual course of business, as reflected on the books of a taxpayer, and in the absence of any circumstances from which sham could be inferred, it is only by artifice and fiction that a conclusion could be drawn that the circumstances are not what they purport to be and that what appears from all the evidence to be loans is to be interpreted as an investment in stock.

There are no circumstances in this case to indicate that the carrying of the advances on the books of the companies as "accounts receivable" and "accounts payable" was a sham or masquerade, or that it did not comport with the actual facts. The transactions in question were those which persons or corporations would be likely to carry out in the usual normal and ordinary course of doing business, just as they, here, appeared to be.

How to define the form of the test that the court should adopt to determine whether an advance of funds to a corporation is to be considered a loan or an investment in the corporation's capital stock is fraught with difficulty, as seen in *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C. A. 2).

However, it can be said that when, upon the entire evidence surrounding the transaction and the consideration of all indicia, including the possible motives of the parties, the nature of the advantages sought, or the detriment

attempted to be avoided, as well as the consideration whether the transaction appears to conform with reality, or resembles a hollow form, an appellate court comes to the definite and firm conviction either that a loan was intended or a capital investment was intended, and that the intent was transmuted into reality—the judgment of the appellate court must follow in accordance with its conclusion, in spite of the contrary findings of a trial court. See *United States* v. *United States Gypsum Co.*, 333 U. S. 364.*

It is our firm and definite conviction that the evidence clearly discloses that the advances by Byerlite were loans to Export, and that Byerlite is entitled to the claimed deduction as a bad debt loss. The identifiable event was the cancellation of the Lago contract, upon the happening of which Byerlite sustained its loss. Our determination makes unnecessary the consideration and disposition of many interesting, intricate, involved, and technical problems, ably presented by counsel, and skillfully resolved by the trial court.

In accordance with the foregoing, the judgment is set aside and the case remanded for entry of judgment in favor of appellant, in accordance with this opinion.

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* To similar effect, see *Peurifoy* v. *Commissioner*, 358 U. S. 59, 60, 61, in which it is said: "Resolution of this case as presented to us turns, therefore, upon a narrow question of fact—Was the petitioners' employment 'temporary' or 'indefinite'? The Tax Court, stating that 'each case must be decided upon the basis of its own facts and circumstances,' * * * found that their employment was temporary. The Court of Appeals, also recognizing that the question was 'one of fact,' held that on the record the Tax Court's finding of temporary employment was 'clearly erroneous.'

"In reviewing the Tax Court's factual determination, the Court of Appeals has made a fair assessment of the record. * * * That being so, this Court will not intervene."

APPENDIX D

Cases Decided in 1959 and 1960 Involving the Question of Whether for Tax Purposes Advances Were to be Characterized as Loans or as Capital Contributions

All the cases appearing in the list below which were decided in 1959 and 1960 required a determination of whether an advance was a loan or a capital contribution. The cases cited below in which the issue of whether an advance was a loan or a capital contribution was directly involved are denoted by the symbol (a). The cases listed below in which the issue was whether a payment by a corporation to its stockholders was to be considered interest or repayment of a prior loan or was to be considered a dividend on an equity interest are denoted by the symbol (b).

1st Circuit

Brake & Electric Sales Corp. v. *U. S.*, 185 F. Supp. 1. (D.C. Mass. 1960) (b).

2nd Circuit

American LaFrance Foamite Corp. v. *Commissioner*, 284 F. 2d 723 (2nd Cir. 1960) (a).

85 Es Realty, Inc. v. *Commissioner*, 59-1 CCH U. S. Tax Cas., Par. 9232 (D.C. N. Y. 1959) (b).

Gilbert v. *Commissioner*, 262 F. 2d 512 (2d Cir. 1959), *cert. den.* 359 U. S. 1002 (1959) (a).

Lowy v. *Commissioner*, 262 F. 2d 809 (2d Cir. 1959) (b).

Appendix D

3rd Circuit

United Engineers & Constructors, Inc. v. *Smith*, 59-1 CCH U. S. Tax Cas., Par. 9322 (D.C. Pa. 1959) (a).

Zephyr Mills, Inc. v. *Commissioner*, 18 CCH Tax Ct. Mem. 794 (1959), *aff'd per curiam* 279 F. 2d 494 (3rd Cir. 1960) (a).

5th Circuit

Bijou-Pensecola Corp. v. *U. S.*, 172 F. Supp. 309 (D.C. Fla. 1959) (a).

Little Enterprises, Inc. v. *U. S.*, 61-1 CCH U. S. Tax Cas., Par. 9154 (D.C. Tex. 1960) (b).

6th Circuit

Byerlite Corp. v. *Williams*, 61-1 CCH U. S. Tax Cas., Par. 9138 (6th Cir. 1960) (a).

Lockwood Realty Corp. v. *Commissioner*, 17 CCH Tax Ct. Mem. 247 (1958), *aff'd per curiam* 264 F. 2d 241 (6th Cir. 1959) (b).

7th Circuit

Arlington Park Jockey Club, Inc. v. *Sauber*, 262 F. 2d 902 (7th Cir. 1959) (a).

Jennings v. *Commissioner*, 272 F. 2d 842 (7th Cir. 1960) (b).

Jones v. *Commissioner*, 59-1 CCH U. S. Tax Cas., Par. 9259 (D.C. Ind. 1959) (a).

Milwaukee & Suburban Transport Corp. v. *Commissioner*, 283 F. 2d 279 (7th Cir. 1960) (b).

Ortmayer v. *Commissioner*, 265 F. 2d 848 (7th Cir. 1959) (a).

Appendix D

8th Circuit

Bruce v. *Knox*, 180 F. Supp. 907 (D.C. Minn. 1960) (b).

9th Circuit

Haley v. *Commissioner*, 60-1 CCH U. S. Tax Cas., Par. 9169 (D.C. Ore. 1960) (b).

O'Neill v. *Commissioner*, 271 F. 2d 44 (9th Cir. 1959) (a).

Royalty Service Corp. v. *U. S.*, 178 F. Supp. 216 (D.C. Mont. 1959) (b).

Wilbur Security Co. v. *Commissioner*, 279 F. 2d 657 (9th Cir. 1960) (b).

Court of Claims

R. C. Owen Company v. *Commissioner*, 180 F. Supp. 369 (Ct. Cl. 1960) (b).

Tax Court

Alan Homes, Inc. v. *Commissioner*, 33 TC 582 (1960) (b).

Allied Stores Corp. v. *Commissioner*, 19 CCH Tax Ct. Mem. 1149 (1960) (a).

Funk v. *Commissioner*, 35 TC , No. 7, (CCH Dec. 24, 401) (1960) (a).

Gloucester Ice & Coal Storage Co. v. *Commissioner*, 19 CCH Tax Ct. Mem. 7015 (1960) (b).

Gokey Properties, Inc. v. *Commissioner*, 34 TC , No. 84, (CCH Dec. 24, 303) (1960) (b).

Hudson v. *Commissioner*, 31 TC 574 (1959) (a).

Potter Electric Signal & Mfg Co v. *Commissioner*, 19 CCH Tax Ct. Mem. 160 (1960) (b).